Outsourcing to Service Providers

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Service Providers (Vendors)

Nearly all firms utilize service providers in the usual course of business, and for many years, it has been a clear regulatory prerogative to perform due diligence on critical service providers. "Firms can outsource functions, but not liability" is a common saying which echoes the oversight obligation.

Since 2014, regulators have primarily highlighted vendor due diligence in the context of cybersecurity; however, recently the regulatory focus is on the broader topic of outsourcing in general. Outsourcing risks are a legitimate concern, and this article will offer practical advice on how to improve oversight of service providers.

For purposes of this article, we will use the term "service providers," which is synonymous to "vendors."

Regulations and Guidance

In 2005, FINRA issued Notice to Members 05-48 (Members' Responsibilities when Outsourcing Activities to Third-Party Service Providers)[1] and reiterated this guidance in Regulatory Notice 21-29 (FINRA Reminds Firms of their Supervisory Obligations Related to Outsourcing to Third-Party Vendors)[2].

The first SEC-proposed rule specific to service provider outsourcing was on February 9, 2022, in SEC proposal "Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies"[3], specifically proposed Rule 206(4)-9(a)(E)(ii) which states:

> *"Require oversight of service providers that receive, maintain, or process adviser information, or are otherwise permitted to access adviser information systems and any adviser information residing therein and through that oversight document that such service providers, pursuant to a written contract between the adviser and any such service provider, are required to implement and maintain appropriate measures, including the practices described in paragraphs (a)(1), (2), (3)(i), (4), and (5) of this section, that are designed to protect adviser information and adviser information systems."*

The guidance to date has been high-level principles-based guidance telling firms what to do, but not how to do it.

SEC Proposed Rule – Outsourcing by Investment Advisers

On October 26, 2022, the SEC proposed Rule 206(4)-11 (Outsourcing by Investment Advisers)[4] and although the text of the proposed rule is only two pages, the Proposal is 232 pages and offers much more detailed guidance. Similar to other recently proposed regulations, the Proposal is more prescriptive.

1. *See* "Notice to Members 05-48 (Members' Responsibilities when Outsourcing Activities to Third-Party Service Providers", FINRA (August 2005), available at: Notice to Members 05-48 | FINRA.org.
2. *See* "Regulatory Notice 21-29 (FINRA Reminds Firms of their Supervisory Obligations Related to Outsourcing to Third-Party Vendors), FINRA (August 13, 2021) available at: Regulatory Notice 21-29 (finra.org).
3. *See* "Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies", U.S. Securities and Exchange Commission (February 9, 2022) available at: Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies.
4. *See* Proposed Rule "Outsourcing by Investment Advisers", U.S. Securities and Exchange Commission (October 26, 2022) available at: Proposed rule: Outsourcing by Investment Advisers (sec.gov).

This proposal is not merely codification of accepted practices; it introduces new regulatory prerogatives, which will require changes in the way firms oversee outsourced functions. Additionally, although the proposed rule is specific to Investment Advisers, there is no practical difference for other firm types including broker-dealers, and investment companies. Firms facing overlapping regulatory requirements regarding oversight of service providers should consider consolidating and/or harmonizing policies and procedures.

Definitions

There are two important definitions in 206(4)-11(b) used in defining the scope of the most recent rule:

Covered Function means a function or service that is necessary for the firm to provide its investment services in compliance with the Federal securities laws, and that, if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the firm's clients or on the firm's ability to provide investment services. A covered function does not include clerical, ministerial, utility, or general office functions or services.[5] While determination of a covered function is a facts and circumstances analysis, the SEC provided examples of potential covered functions in its proposal, including:

- Adviser / Subadvisor
- Client Services;
- Cybersecurity;
- Investment Guideline / Restriction Compliance;
- Investment Risk;
- Portfolio Management (excluding Adviser / Subadvisor);
- Portfolio Accounting;
- Pricing;
- Reconciliation;
- Regulatory Compliance;
- Trading Desk;
- Trade Communication and Allocation; and
- Valuation.

The proposal specifically notes that it does not include an exception for service providers that are subject to the Advisers Act or other Federal securities laws.[6] However, custodians that are independently selected and engaged by a client would not fall within the scope of proposed Rule 206(4)-11(b).[7]

Service Provider means a person or entity that performs one or more Covered Functions and is not a supervised person of the firm.[8]

Due Diligence

The proposed rule requires registered investment advisers to conduct due diligence prior to engaging a service provider for a critical function and before adding additional covered services to an existing engagement. The term "due diligence" is used in many contexts, ranging from

AML customer due diligence to due diligence of investment products, investment managers and service providers. The proposal provides specific guidelines for the due diligence requirements that would apply in the context of engaging a service provider for a critical function.

5. IBID page 16.
6. IBID page 27.
7. IBID page 21.
8. IBID page 20.

Six Required Elements in Due Diligence

Proposed Rule 206(4)-11(a)(1) stipulates six required elements in due diligence:

1. Determine the nature and scope of the services
2. Identify potential risks resulting from the service provider performing the covered function, including how to mitigate and manage such risks
3. Determine the service provider's competence, capacity, and resources necessary to perform the covered function
4. Consider the service provider's subcontracting arrangements related to the covered function
5. Coordinate with the service provider for Federal securities law compliance
6. Obtain reasonable assurance of an orderly termination of the provision of the covered function by the service provider

Required Element #1 – Determine the nature and scope of the services

To satisfy the first required element, firms should identify the services and document how they rise to the definition of a covered function. The Proposal also states, "As part of this analysis, an adviser also might wish to identify the frequency, content and format of the services provider's covered function."[9] Meeting this requirement will vary depending on the facts and circumstances, but may be accomplished through, for example, a written agreement with the service provider or memo to the file.

Required Element #2 – Identify potential risks resulting from the service provider performing the covered function, including how to mitigate and manage such risks

The proposal summed up this requirement in just one sentence (albeit a long one.)[10]

> *"There are a variety of potential risks that an adviser should generally consider, such as the sensitivity of information and data that would be subject to the service or to which the service provider may have access, the complexity of the function being outsourced, the reliability and accuracy of the service or function delivered by the service provider, extensive use of particular service providers by the adviser or several advisers, available alternatives in the event a service provider fails or is unable to perform the service, the speed with which a function could be moved to a new service provider, existing and potential conflicts of interest of the service provider, geographic location of the service provider, unwillingness to provide transparency, known supply-chain challenges, and the availability of market resources skilled in the service."*

For anyone experienced in performing due diligence on service providers, this element will have some familiarity. However, most compliance policies and procedures are designed to avoid subjectivity. To describe how identified risks are mitigated and managed will almost certainly require some subjective responses. This presents challenges in execution and quality control. Consider a review of a completed due diligence report. The reviewer might have a different opinion as to whether, or not, the subjective response is adequate. Not only has the SEC become more prescriptive, but the proposal would force firms to comply with subjective expectations when fulfilling due diligence and complying with other components of the proposal.

9. IBID page 45.
10. IBID page 46.

Required Element #3 – Determine the service provider's competence, capacity, and resources necessary to perform the covered function

As in #2 above, some subjectivity will be required especially regarding competence and capacity. The difference is subtle. Most of us are performing due diligence looking for issues and exclusionary information. The proposed rule views service provider due diligence from the point of inclusion, in other words, how the service provider is qualified. While this is a subtle difference, it requires change and subjectivity.

Required Element #4 - Determine if the service provider's subcontracting arrangements impact the covered function of the firm

We would all agree it is challenging to assess one's own risks. Assessing someone else's risks is difficult and this element requires firms to go down the daisy chain to our service providers vendors. Fortunately, the proposed rule states[11]:

> *"In making these determinations, an adviser generally could rely on representations provided by the service provider or could develop policies and procedures with certain limitations or conditions when engaging a service provider that uses subcontractors."*

Required Element #5 - Coordinate with the service provider for Federal securities law compliance

Of the six required elements of due diligence, this one likely aligns with many current due diligence practices. The proposed rule states[12]:

> *"The proposed due diligence provision would require an adviser to obtain reasonable assurance from a service provider that it is able to, and will, coordinate with the adviser for purposes of the adviser's compliance with the Federal securities laws, as applicable to the covered function. An adviser remains liable for its obligations, including under the Advisers Act, other Federal securities laws and any contract entered into with the client, even if the adviser outsources functions. The proposed requirement would alert the service provider to those responsibilities and obtaining reasonable assurances would help the adviser ensure that it can continue to meet its compliance obligations despite outsourcing those functions."*

Required Element #6 – Obtain reasonable assurance that the service provider will provide an orderly termination of the provision of the covered function

Many firms have experienced issues when terminating services; however, most due diligence questionnaires and checklists do not address the orderly termination of services. In extreme cases, services providers have been hostile and have held the firm's data hostage. Thus, the addition of this required element is welcomed.

When possible, this element should be addressed through the termination clause of the service agreement. Some agreements contain "divorce clauses" which detail contractual provisions to ensure an orderly termination and transition to a new service provider. Factors that firms should consider include, but are not limited to:

(1) Method of data transferred;
(2) Timeline for transfer;
(3) Which party is responsible for transfer of data and any format requirements;
(4) Whether additional fees apply; and
(5) When data will be destroyed following transfer.

11. IBID page 54.
12. IBID page 57.

Firms should consider the potential of overlap with business continuity planning. Many service providers rely on their client's data to be successful. Ideally, firms should require regular independent backups of their data by service providers to protect against a catastrophic event.

Proposed Amendments to Rule 204-2 (Books and Records)[13]

The current Books and Records rule does not prescribe requirements for when an adviser outsources one or more required recordkeeping functions to a third party. Under the proposed rule, the recordkeeping obligation is extended to records held by a third party.

Proposed Amendments to Form ADV

The SEC proposed adding Form ADV Part 1a, Item 7.C which would require SEC-registered advisers to:

(1) indicate whether they outsource any covered functions to a service provider;
(2) disclose information of each such service provider including legal and primary business names of the service provider, legal entity identifier, and address of service provider;
(3) indicate whether an identified service provider is a related person of the adviser;
(4) state the date the service provider was first engaged; and
(5) indicate the covered function(s) that the service provider is engaged to perform.

Policies and Procedures

While the SEC expects firms to conduct vendor due diligence on key service providers, many firms have not yet adopted written policies and procedures addressing outsourcing. Those that do will need to update their policies and procedures to conform to the proposed rule.

Included with this article is a template "Policies and Procedures for Service Providers," which is available in the NSCP Resource Library. In most cases it is prudent to defer updating policies and procedures until a proposed rule goes final. However, given the SEC's current guidance for firms to oversee service providers, this might be an exception. The Proposal has some helpful elements to strengthen any firm's oversight of service providers.

Service Provider Due Diligence Questionnaire ("DDQ")

Included with this article is a "Service Provider Due Diligence Questionnaire," which has been formatted to comply with the proposed rule.

Note: Both the policies and procedures template and the template DDQ have been formatted without reference to the proposed rule so they also can be utilized by broker-dealers, and investment companies.

The Proverbial "Elephant in the Room"

Anyone who has done due diligence on service providers knows the harsh reality of efforts stymied when service providers refuse to cooperate. Document your efforts and do the best you can to utilize publicly available resources when necessary.

13. IBID pages 224-226.

The proposed rule requires ongoing monitoring with good reason. Issues do occur with service providers. When issues arise, such as a data breach, firms should use the opportunity to evaluate if there were red flags during the due diligence process and update firm processes accordingly.

Conclusion

The proposed rule is a game-changer. For the first time we have prescriptive rulemaking for performing oversight of service providers. This should lead to better outcomes for firms and the service providers to ultimately strengthen infrastructure throughout the industry. ■